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Rating Update: Moody's downgrades Cincinnati's (OH) GO to Aa2 from Aa1; downgrades economic development, non-tax revenue and Convention Facilities Second Lien Revenue, Series 2004 debt to Aa3 from Aa2; Outlook revised to negative

Global Credit Research - 15 Jul 2013

Aa2 rating applies to $520.4 million of post-sale general obligation unlimited tax debt

CONVENTION FACILITIES AUTHORITY OF HAMILTON COUNTY, OH
Cities (including Towns, Villages and Townships)
OH

Opinion

NEW YORK, July 15, 2013 --Moody's Investors Service has downgraded to Aa2 from Aa1 the rating on the City of Cincinnati's (OH) general obligation unlimited tax debt. Concurrently, Moody's has downgraded to Aa3 from Aa2 the rating on the city's outstanding economic development and non-tax revenue debt and the Convention Facilities Authority of Hamilton County's Second Lien Revenue Bonds, Series 2004. The outlook has also been revised to negative. The Aa2 rating applies to $520.4 million of outstanding general obligation unlimited tax debt. The Aa3 rating applies to $101.4 million of economic development and non-tax revenue debt and $18.1 million of the Convention Facilities Authority of Hamilton County's Second Lien Revenue Bonds, Series 2004 (an additional $11.9 million has been legally defeased).

SUMMARY RATING RATIONALE

The city's general obligation debt is secured by the city's general obligation unlimited tax pledge. The downgrade to Aa2 reflects the city's exposure to two statewide multi-employer cost-sharing pension plans as well as the city's single-employer plan; the city's pressured but still satisfactory financial position, including the recent stabilization of income tax revenues; moderate financial flexibility provided by available but unused levy authority; the city's economically diverse economic base; relatively weak socio-economic indices; above average debt position with significant sources of non-levy support; and the relatively strong funded position of the city's single-employer plan OPEB liabilities.

The Aa3 rating on the economic development non-tax revenue debt is based on the credit characteristics inherent in the Aa2 general obligation rating; the legal provisions of the master and supplemental trust indentures that govern the city's economic development non-tax revenue debt; and the satisfactory debt service coverage provided by specific non-tax General Fund revenues.

The Aa3 rating on the Convention Facilities Authority of Hamilton County's Second Lien Revenue Bonds, Series 2004 is based on the legal structure, in particular the city's pledge to replenish the Contingent City Rent Fund and Revenue Stabilization Fund, if primary pledged city and county hotel tax revenues are insufficient to pay debt service.

The negative outlook reflects the expectation that the city will continue to face challenges in attaining structurally balanced operations, stemming from its unfunded pension liabilities and reliance on a number of one-time budgetary solutions in recent years.

The city's rating was placed on review for downgrade due to its large adjusted net pension liability relative to its rating category as part of our new approach to analyzing state and local government pension liabilities. For further details please see the April 17, 2013 release of "Moody's announces new approach to analyzing state, local, government pensions; 29 local governments placed under review." The review has been completed with the downgrade of the city's general obligation rating to Aa2, the downgrade of the city's economic development and non-tax revenue debt to Aa3, and the downgrade of the Convention Facilities Authority Second Lien Revenue Bonds, Series 2004 to Aa3. We believe the Aa2 GO rating incorporates the city's sizeable adjusted net pension liability as well as the city's other long-term credit fundamentals.

STRENGTHS

-Resumed growth of income tax revenues trends following declines in recent years

-Retained financial flexibility afforded by available but unused levy authority

-Diverse regional economy anchored by numerous corporate headquarters, health care organizations, and higher education institutions

-Healthy GAAP-basis General Fund reserves

CHALLENGES

-Reliance on economically sensitive income tax revenues for the majority (67%) of General Fund revenues; income tax collections declined considerably during the economic downturn

-Substantial budget gaps during recent fiscal years required significant expenditure reductions and one-time budgetary solutions, which may limit cost cutting options to address future pressures

-High pension burden associated with the city's exposure to two statewide multi-employer cost-sharing plans, as well as the city's single employer plan for which annual contributions are well below actuarial requirements

-Resident per capita and median family income levels lag those of similarly rated credits

FINANCIAL OPERATIONS REMAIN CHALLENGED IN FISCAL 2014; CITY CHANGED FISCAL YEAR IN 2013

Prior to fiscal 2011, Cincinnati's financial position weakened for consecutive years due primarily to shortfalls in revenues derived from the city's 2.1% income tax, which is assessed on all individuals who live or work in the city and on corporate profits generated by businesses in the city. Following six consecutive years of income tax revenue growth, collections declined in fiscals 2009 (by 5.5%) and 2010 (by 0.6%). Favorably, income tax revenue rebounded in fiscal 2011, increasing by 5.1% from the prior year. The city's financial profile is highly vulnerable to downturns in this economically sensitive revenue source, as income tax revenues represented 67% of General Fund revenues in fiscal 2011. However, we believe that the city's financial operations will remain fundamentally sound due to management's quick response to recent shortfalls and its demonstrated commitment to implementing budgetary adjustments to preserve fund balance within its minimum policy, as indicated by unaudited results for fiscal 2012.

Following declines in income tax revenues in fiscal 2009, the fiscal 2010 budget incorporated projections of continued revenue declines, including a 3.7% drop in income tax revenues, as well as additional expenditure cuts, most notably a reduction of 212 full time equivalents (FTEs). Due in part to positive variances in income tax collections which declined by just 0.6% rather than the budgeted decline of 3.7%, the non-GAAP basis General Fund balance increased by $8.5 million to $23.8 million in fiscal 2010. The GAAP basis General Fund balance declined by $4.6 million to a still satisfactory $85.4 million, or 24.4% of revenues. Driven by improved income tax revenues in fiscal 2011 combined with expenditure reductions across a number of departments, the city's GAAP basis General Fund balance increased to $99.8 million in fiscal 2011, or an improved 28.6% of revenues. While audited results are not yet available for fiscal 2012, the city indicates that it ended the year with a flat GAAP basis General Fund balance relative to fiscal 2011. The city's fiscal 2012 budget originally called for a General Fund non-GAAP basis fund balance decline of approximately $13.8 million, despite $11.1 million in expenditure reductions, one-time expenditure shifts to alternate funds and $11 million in one-time revenue enhancements from a renegotiated Convergys deal. Unaudited results compare favorably to these original expectations due to positive variances for both revenues and expenses.

City officials project and monitor financial operations on a budgetary basis, rather than a GAAP basis. Minimum reserve policies are also developed on a budgetary basis. On this budgetary basis, reserve levels are classified and monitored according to the three categories: the General Fund carry over amount (which is the annual budget-to-actual variance in the General Fund); the Emergency Reserve; and the Working Cash Reserve (WCR). A long standing city policy calls for the total of these three reserves to equal a minimum of 10% of total General Fund revenues on a budgetary basis. Additionally, the reserve policy calls for the maintenance of a WCR balance that equals between 5% and 8% of total General Fund revenues. On a GAAP basis, these three components of the city's reserve are included the General Fund audited financial statements. Although our analysis incorporates the city's reports on these three reserve categories, we also consider the General Fund GAAP balance and the audited General Fund cash basis fund balance as important indicators of the city's financial position.

As measured by the three reserve categories tracked by city management, General Fund reserves, on a non-GAAP basis, improved in fiscal 2011 to $44.8 million, or 12.8% of General Fund revenues on a budgetary basis. The reserve total was composed of a General Fund carry over amount of $22.3 million, a $2.4 million Emergency Reserve, and $20.1 million WCR. Unaudited fiscal 2012 results indicate similar balances at year end. We believe that city management's continued compliance with its minimum reserve policies during a multi-year period of budgetary stress supports the city's Aa2 general obligation rating and is important given the relative narrowness of Cincinnati's budgetary basis reserve levels.

The city changed its fiscal year end from December 31 to June 30, beginning June 30, 2013 in part to provide newly elected officials sufficient time between taking office and voting on the city's budget. As a result, the city's fiscal year 2013 only lasted 6 months, from January 1 to June 30, 2013. The city's preliminary year end result indicate that operations remained balanced for the 6-month fiscal year, although the fiscal 2014 budget currently projects General Fund expenses will exceed revenues by approximately $15 million. We note that city's recent financial results have consistently compared favorably to original projections and expect similar positive variances in the final audit. Should reductions in liquidity or reserves occur as the city identifies and implements budgetary solutions, particularly given the city's partial reliance on one-time budgetary solutions in recent years, credit quality may be further affected.

UNUSED LEVY AUTHORITY PROVIDES FINANCIAL FLEXIBILITY

Cincinnati's financial profile is strengthened by the availability of unused levy authority. The city is authorized to use property taxes to support all of its GOULT debt service obligations, but management uses income tax revenues to support a portion of its GOULT debt service. Officials estimate that levying the full authorized amount would generate an additional $2.2 million in annual property tax revenues, which would free up other revenues for operations. This amount of flexibility was previously $7.5 million prior to city's recent levy increase. No voter approval is required to levy this additional amount. While there may be political consequences to suspending the city's long-standing practice of abating this portion of its levy, we believe that the ability and willingness of the city to access this revenue source if needed to establish balanced operations is an important component of the Aa2 general obligation rating.

ECONOMICALLY DIVERSE URBAN TAX BASE BENEFITS FROM CONTINUAL PUBLIC AND PRIVATE INVESTMENT; RELATIVELY WEAK SOCIO-ECONOMIC INDICES

Cincinnati will likely continue to benefit from its role as a regional trade, transportation, sports and entertainment, and employment center for southwest Ohio and portions of Kentucky and Indiana. The regional presence of several corporations remains strong and continues to support the overall economic diversity of the base. Kroger (senior unsecured rated Baa2/stable outlook), the region's largest employer, and Procter & Gamble (senior unsecured Aa3/stable outlook), both maintain their corporate headquarters in Cincinnati. Other top employers include the federal government, the University of Cincinnati (general receipts rated Aa3/stable outlook), Children's Hospital Medical Center, and Health Alliance of Greater Cincinnati. As of May 2013, Cincinnati's unemployment rate (7.6%) tracked above the state (6.9%) and the nation (7.3%).

The city, in partnership with private developers, has undertaken numerous economic development projects. A major project, The Banks, benefits from the realignment of interstate roads through the downtown allowing for the development of area adjacent to the Ohio River for sports and recreation (the project is anchored by the football and baseball stadiums), as well as commercial development. In 2010, state voters authorized the construction of four casinos, one of which is located in downtown Cincinnati. City of Cincinnati officials project that the casino will add up to 1,700 permanent jobs upon completion. The city also projects it may receive approximately $10 million in annual casino tax revenue as all four casinos have opened.

Cincinnati's sizeable estimated $14.7 billion property tax base has declined in valuation at an average annual rate of 3.3% during the past five years, which reflects both the limited appreciation of existing properties and the impact of House Bill 66, which had an aggressive phase-out schedule for tangible personal property values. We expect the city's tax base to continue to stagnate over the next several years, but growth trends should resume in the long term as property values begin to appreciate and new construction begins to offset the impact of the phase-out. The city's socioeconomic profile has historically been weaker than those of similarly rated credits, with Cincinnati residents' 2006 to 2010 per capita income and median family income equal to 87.7% and 72.7% of the nation, respectively. It is important to note that,the city relies primarily on income taxes levied on those working in the city and the income profile of the city's key tax payers is likely stronger than those of its residents, given the nature of the jobs within the city.

ANNUAL PENSION FUNDING OF CITY RETIREMENT SYSTEM PRESENTS ONGOING BUDGETARY

CHALLENGE DESPITE RECENT REFORMS; CITY ALSO HAS SIGNIFICANT EXPOSURE TO STATEWIDE COST-SHARING PLAN UNFUNDED LIABILITIES;

The city has a high employee pension burden, based on unfunded liabilities associated with its share of two multi-employer statewide cost-sharing plans, as well as the single-employer Cincinnati Retirement System (CRS). Moody's has allocated liabilities of statewide cost-sharing plans to the city in proportion to its contributions to each plan for analytic purposes. The city's fiscal 2011 share of unfunded pension liabilities allocated by Moody's on a reported basis consist of an estimated $380 million share of the Ohio Police & Fire plan (OP&F) and an estimated $17 million share of the Ohio Public Employees Retirement System (OPERS). Statutory contribution requirements, particularly for OP&F, have been far less than actuarial requirements in recent years. The city has consistently made its full statutory requirements to the multi-employer cost-sharing plans.

Favorably, the state implemented retirement system benefit reforms effective January 2013 that are expected to lower unfunded pension liabilities, although updated actuarial valuations are not yet available. While the city's exposure to the unfunded liabilities of these cost-sharing plans poses a substantial long-term risk, we note that the reform legislation held statutory employer contributions constant as a percentage of covered payroll, while focusing most changes on employee benefits and contribution rate increases. As a result, we do not believe the city's exposure to these unfunded liabilities represents a near-term budgetary risk. However, to the extent that the reforms implemented by the state may be insufficient to bring contributions in line with a 30-year statutory funding requirement and to address the significant unfunded liabilities of the cost-sharing plans, there is a significant risk to participating local governments that the state could exercise its option to increase employer contribution rates in an effort to improve the funding of the statewide cost-sharing plans.

The Cincinnati Retirement System reports as a single-employer plan, although it serves employees from several separately-rated enterprises within the city, such as the water and sewer systems. The city's single employer pension plan has experienced sharp investment losses and escalated funding requirements in recent years. Declines in the city's pension funded ratio on a reported basis from 86% in fiscal 2007 to 61% in fiscal 2012 reflect a variety of factors, including investment declines in 2008 and 2011, a multi-year pattern of annual contributions that have fallen short of actuarially required amounts, and the reduction of the system's discount rate from 8% to 7.5%, which took effect in the 2011 actuarial valuation. According to the system's fiscal 2012 actuarial report, contributions to the system as a whole were approximately $16 million less than the actuarially determined amount, and have fallen short of this annual requirement by as much as $50 million as recently as 2010. Favorably, the city implemented a variety of changes aimed at reducing accrued pension liabilities at the recommendations of the pension board, including increasing employer and employee contributions on a gradual basis through fiscal 2015, increasing the retirement age, decreasing the annual cost of living adjustment for active employees and calculating an employee's highest average salary using the last five years of employment rather than three years. Importantly, some of these changes are currently the subject of litigation, the outcome of which is unknown. Should the city not prevail, unfunded pension liabilities would likely increase. Furthermore, the city and pension board have reviewed analyses of COLA changes that would impact current retirees, and although no action has been taken to date, these changes could represent an additional option available to the city to reduce pension liabilities. On a reported basis, the unfunded liability of the city's single-employer plan was $862 million as of December 31, 2012.

Moody's adjusted net pension liability (ANPL) for the city as of fiscal 2011, under our methodology for adjusting reported pension data, is $1.6 billion, or a high 3.8 times operating revenues, including the General Fund and Debt Service fund, compared to approximately 1.0 times on average for local governments. This is comprised of approximately $690 million associated with the CRS, $866 million associated with OP&F, and $35 million associated with OPERS. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace the city's reported contribution and liability information, or the reported liability information of the statewide cost-sharing plans, but to improve comparability with other rated entities. We note that the ANPL referenced above has backed out all liabilities that we attribute to the water and sewer enterprises that serve the city and surrounding area. Additionally, this figure also backs out liabilities in proportion to pension contributions from dozens of small, non-major funds. The city's ability to continue to manage this long-term liability will be critical in our ongoing reviews.

HIGH DEBT BURDEN; CONSERVATIVE DEBT PROGRAM WITH NO VARIABLE RATE DEBT OR SWAPS

Given moderate capital needs going forward, we anticipate that the city's debt position will remain high but somewhat mitigated by the use of non-levy sources to support debt service. The city's overall debt burden is well above average at 8.4% of estimated full value, but this figure includes significant school district and county overlapping obligations, as well as city debt supported by revenue sources other than property taxes. When adjusted for debt currently supported by enterprise revenues, the city's overall debt burden is a more manageable,

but still above average 6.6% of full value. The city's direct debt burden is also above average at 4.1% of estimated full value. The city retires its debt fairly quickly, with a ten year principal amortization rate of 72% for GOULT debt and 63% for GOULT and non-tax revenue economic development debt combined. Future borrowing for the city's five-year capital improvement plan is expected to be moderate with between $15 million and $23 million of additional general obligation borrowing planned annually over the next five years. However, management indicates that and additional borrowing of up to $60 million in fiscal 2014 is also being considered. All of Cincinnati's debt is fixed rate, and the city is not a party to any interest rate swap agreements.

Outlook

The outlook on the City of Cincinnati is negative, reflecting our expectation that the city will continue to face budgetary pressure stemming from required pension contributions to the City Retirement System and potential long-term pressure from its exposure to statewide multi-employer cost-sharing pension plans. Further, the city has a budget with General Fund expenses exceeding revenues for the current fiscal year 2014. While the city has a track record of achieving better operating results than its initial budgets and forecasts, it has also maintained its financial position in recent years in part by relying on one-time budgetary solutions and not contributing the full actuarially required contribution to its single-employer pension plan, which indicates a current lack of structural balance. A failure to regain structural balance could result in further deterioration in the city's credit rating.

WHAT COULD CHANGE THE RATING UP (or revise the outlook to stable)

-Expenditure reductions and/or implementation of revenue enhancements that move the city towards structurally balanced operations

-Economic expansion that leads to resumed valuation growth

-Significant improvement of resident income levels, unemployment rates, and other socioeconomic indicators that have historically lagged those of similarly rated credits

-Substantial reduction of unfunded pension liabilities and annual funding of actuarially required contributions

WHAT COULD CHANGE THE RATING DOWN

-Negative budget variances coupled with an inability or unwillingness to implement corresponding expenditure reductions or alternate revenue generators

-Further declines in liquidity and/or fund balances to levels materially below fiscal 2012 reserves

-Inability to enact long-term pension contribution strategy to improve funded status of CRS

-Increased exposure to unfunded pension liabilities

-Economic stagnation that impedes tax base growth and detracts from the success of economic revitalization efforts

KEY STATISTICS

2010 Population: 296,943 (10.4% decrease from 2000)

2012 Estimated full valuation: $14.7 billion (average decline of 3.3% annually over the last five years)

2012 Estimated full value per capita: $49,564

2010 Per capita income as % of US: 87.7% (2006-2010 American Community Survey)

2010 Median family income as % of US: 72.7% (2006-2010 American Community Survey)

May 2013 unemployment rate: 7.6%

Fiscal 2011 General Fund balance (GAAP basis): $99.8 million (28.6% of revenues)

Direct debt burden: 4.1%

Overall debt burden: 8.4%

Fiscal 2011 Moody's Adjusted Net Pension Liability (ANPL): 3.8x operating revenues, excluding non-major governmental fund and enterprise pension contributions

GOULT and non-tax revenue debt 10 year payout: 63.3%

Post-sale GOULT debt outstanding: $520.4 million

Economic Development Revenue (Non-tax revenue) debt outstanding: $101.4 million

CFA of Hamilton County Second Lien Revenue Bonds, Series 2004 outstanding: $18.1 million ($11.9 million of which has been defeased)

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was General Obligation Bonds Issued by US Local Governments published in April 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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Analysts

Thomas Aaron
Lead Analyst
Public Finance Group
Moody's Investors Service

Jeffery Yorg
Additional Contact
Public Finance Group
Moody's Investors Service

Hetty Chang
Additional Contact
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.

250 Greenwich Street
New York, NY 10007
USA

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